

***United States Court of Appeals  
for the Second Circuit***



**APPELLANT'S  
REPLY BRIEF**



# 77-6005

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In the  
**United States Court of Appeals**  
**FOR THE SECOND CIRCUIT**

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DOCKET NO. 77-6005

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SECURITIES INVESTOR PROTECTION CORPORATION,

*Applicant,*

vs.

EXECUTIVE SECURITIES CORPORATION,

*Defendant.*

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SECURITIES AND EXCHANGE COMMISSION,

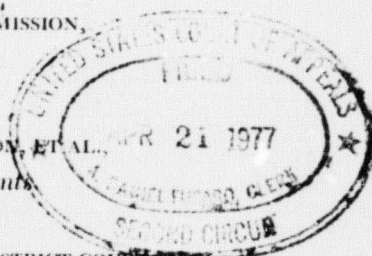
*Plaintiff,*

vs.

EXECUTIVE SECURITIES CORPORATION, ET AL.,

*Defendants.*

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ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF NEW YORK

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**REPLY BRIEF OF CLAIMANT—APPELLANT**  
**YALE UNIVERSITY**

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ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
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REPLY BRIEF OF APPELLANT  
YALE UNIVERSITY

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### Preliminary Statement

Cameron F. MacRae, III ("Trustee"), and the Securities Investor Protection Corporation ("SIPC"), appellees in this appeal, filed a joint brief (the "SIPC/Trustee Brief") with this Court on April 7, 1977, in accordance with this Court's Scheduling Order Number 2.

Most of the arguments presented by the SIPC/Trustee brief are discussed in the brief filed by Yale University on February 18, 1977. This reply brief discusses certain additional points raised by the SIPC/Trustee brief.

### I.

#### THE SIPC/TRUSTEE BRIEF IGNORES THAT PORTION OF CONGRESS'S DEFINITION AT ISSUE IN THIS APPEAL

The first argument of the SIPC/Trustee brief is based upon the assertion that, in connection with securities loans such as the ones at issue in this appeal, "nothing is held, or intended to be held, by the broker for the lender's account." (SIPC/Trustee Brief at 12) That argument rests solely on a portion of the definition of "customers" not at issue here.

The argument would have this Court focus entirely on the words "held . . . for the account of" in the definition of "customers" while completely ignoring the language applicable to Yale (*italicized below*):

"customers" of a debtor means persons . . . who have claims on account of securities *received*, acquired, or held *by the debtor from* or for the account of *such persons*. [15 U.S.C. § 78fff(c)(2)(A)(ii)]



Yale has never suggested that the loaned securities were held by Executive "for Yale's account." The definition is clearly disjunctive, and no authority cited in the SIPC/Trustee brief supports its exclusionary reading of Congress's definition of "customers."<sup>1</sup>

In short, the first SIPC/Trustee argument is a straw man designed to lead this Court away from that portion of Congress's definition of "customers" that is relied upon by Yale and is at issue in this appeal. (Yale Brief at 9)

## II.

### THE SIPC/TRUSTEE BRIEF MISCONSTRUES THE HOLDING IN *Baroff*

The proper application of *SEC v. F. O. Baroff Co.*, 497 F.2d 280 (2d Cir. 1974), is central to this appeal. Two points raised by the SIPC/Trustee brief deserve comment.

First, that brief emphasizes the language in *Baroff* concerning the lack of "the indicia of the fiduciary relationship between a broker and his public customer." 497 F.2d at 284. (SIPC/Trustee Brief at 12-15 and at 18) This Court could

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<sup>1</sup> The SIPC/Trustee brief emphasizes language from *Provost v. United States*, 269 U.S. 443, 455-456 (1926), a case that dealt with the applicability of a stamp tax to securities loans under the Revenue Acts of 1917 and 1918. Although that decision reveals the existence of securities loans long before the enactment of Section 60e of the Bankruptcy Act, 11 U.S.C. § 96(e), it did not consider, even in dictum, the status of securities lenders as creditors of a broker, which is the issue in this appeal.

not have intended the quoted language to require the existence, in a technical sense, of a fiduciary relationship between a broker and its customers in light of Congress's explicit language to the contrary:

"customers" of a debtor means persons (*including persons with whom the debtor deals as principal or agent*) who have claims . . .

15 U.S.C. § 78fff(c)(2)(A)(ii) (emphasis supplied).

The suggestion that there must be a fiduciary relationship appears to stem from the use by several courts of "entrustment" language. For example, the *Baroff* opinion states that the legislative history of Section 60e relates to "the public customer who has entrusted securities to a broker for some purpose connected with participation in the securities markets." 497 F.2d at 283. The SIPC/Trustee brief states that "every court which has addressed the question" has limited the protected class to those "who entrust cash or securities to their broker . . ." (SIPC/Trustee Brief at 8, citing numerous decisions at note 10)

Reliance on this "entrustment" theory, and the corollary requirement for a fiduciary relationship, ignores both the principal reason that Congress enacted Section 60e and the legal significance of the distribution scheme set out in that provision and carried forward in the 1970 Act: *i.e.*, to reverse by statute the Supreme Court decisions<sup>2</sup> that had adopted the New York rule treating stockbrokers as pledgees to whom stock was "entrusted" by their customer-pledgors, and to replace that rule

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<sup>2</sup> *Richardson v. Shaw*, 209 U.S. 365 (1908); *Gorman v. Littlefield*, 229 U.S. 19 (1913); and *Duel v. Hollins*, 241 U.S. 523 (1916).

with the Massachusetts rule, which treated stockbrokers as debtors of their creditor-customers. Congress was well aware that it was nullifying the "entrustment" requirement:

Moreover, the amendatory section proposes to require, by statute, that the bankruptcy courts shall adopt the Massachusetts rule, so-called, whereby the relation between a stockbroker and his customer is, in effect, that of creditor and debtor, buyer and seller, instead of the New York rule, so-called, which preserves the relation between a stockbroker, entrusted with the customer's stock, and his customer, so entrusting his stock to the broker, as that of pledgee and a pledgor, with all the implications of such a trust relationship.<sup>3</sup>

Thus, although it is apparent that several courts have used the word "entrusted," apparently as a shorthand for the more cumbersome statutory phrase "received, acquired, or held," it is clear that Section 60e was specifically designed to reject the fiduciary relationship based upon entrustment doctrine in favor of a debtor-creditor relationship. Adoption of the SIPC/Trustee position would engraft onto the 1970 Act a requirement for the entrustment of securities with a broker-dealer, thereby ignoring Congress's intent and nullifying a central purpose of Section 60e and of the 1970 Act.

Second, the SIPC/Trustee brief asserts that this Court held in *Baroff* that only persons who maintain trading accounts

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<sup>3</sup> Statement of Harold Remington, Hearings on H.R. 6439 and H.R. 8046 Before the House Comm. on the Judiciary, 75th Cong., 1st Sess., ser. 9, at 234 (1937); see also testimony of Harry Zalkin, *id.* at 96, and testimony of Prof. J. A. McLoughlin, *id.* at 125-130 ("The situation with reference to stockbrokers' bankruptcy is, briefly, that it is necessary to overrule all of the Supreme Court cases." *id.* at 125).



with a broker-dealer can be customers of that broker-dealer. (SIPC/Trustee Brief at 20) This Court did not so hold. In fact, Baroff had "opened an account in Lubin's name" in connection with the loaned securities, although the lender "did not have a live account with the firm at the time he made the loan." 497 F.2d at 281. In *Baroff* this Court was not faced with, and did not pass on, the question of whether or not a person must maintain a "trading account" with a broker-dealer in order to be a customer. And the 1970 Act contains no such requirement. See Yale Brief at 13.

### III.

#### THE RIGHT TO MARK TO MARKET DOES NOT PRECLUDE CUSTOMER STATUS

The SIPC/Trustee brief repeatedly emphasizes that Yale had a "contractual right" to mark to market and that such a right precludes Yale from customer status. (See, *e.g.*, SIPC/Trustee Brief at 28.)

The "mark to market" argument may be an appealing method of belittling Yale's claim (*e.g.*, Yale could have avoided its losses; therefore Yale should have avoided its losses; and therefore Yale does not deserve the customer protections created by Congress), but the argument is specious. The argument is not based upon anything in the 1970 Act, or in Section 60e of the Bankruptcy Act, or in the legislative history of either act.

Furthermore, the argument is premised upon an unstated diligence requirement. Every customer has at least an implied "contractual right" to withdraw securities left with a broker-dealer for safekeeping, or with a view toward future

sale, or pursuant to purchases. Likewise, any customer has the right to withdraw cash left with a broker. The only difference between the foregoing rights and Yale's right is that Yale had a written agreement and was partially collateralized. In his testimony before Congress concerning the Chandler Act, Professor McLaughlin, the principal draftsman of Section 60e and the definition of "customers," answered those who, like SIPC, would impose a diligence requirement on customers of a broker-dealer:

As Mr. Glenn has sagely remarked, however, any reasonable man ought to know that a broker's office is no place to leave money or securities for safekeeping.

Prof. J. A. McLaughlin, Hearings on H.R. 6439 and H.R. 8046 Before the House Comm. on the Judiciary, 75th Cong., 1st Sess., ser. 9, at 131 (1937), discussed in Yale Brief at 29.

Congress has chosen to limit the *amount* of protection available to customers rather than to deny all protections to those persons who may be in a better position to protect themselves or absorb their own losses. In contrast, SIPC and the Trustee appear to believe that institutional investors such as Yale do not *need* the protection of the 1970 Act and thus should be excluded from the definition of "customers." (SIPC/Trustee Brief at 10)

Thus, even though Yale and other customers may have "contractual rights," that, if diligently exercised, would reduce many of the losses caused by broker-dealer bankruptcies, Congress has chosen to provide the protections embodied in the Securities Investor Protection Act of 1970. And Congress has

explicitly included securities lenders such as Yale among the customers so protected.<sup>4</sup>

#### IV.

#### THE SIPC/TRUSTEE BRIEF URGES THE JUDICIAL REPEAL OF SUBSECTION VI OF THE DEFINITION OF "CUSTOMERS"

The SIPC/Trustee brief would have this Court repeal subsection VI of Congress's definition ("or (VI) by way of loans of securities by such persons to the debtor"), even though Congress has refused to repeal that language (Yale Brief at 14).

The SIPC/Trustee brief states that Yale would be a "customer" if it had had a "trading account" with Executive and the loaned securities had originally been "placed . . . in that account for trading or safekeeping purposes." (SIPC/Trustee Brief at 22)<sup>5</sup>

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<sup>4</sup> The mere fact that a customer may have contractual rights vis-a-vis a broker-dealer does not nullify the customer's rights under the 1970 Act. To the contrary, the definition of "customers" necessarily encompasses persons with contractual rights by specifically excluding from the definition "any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor." Yale's contractual rights, and therefore its claim, do not fall within that exclusion.

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<sup>5</sup> The SIPC/Trustee brief lists a third test: only securities loans made in accordance with Section 8(c) of the Securities Ex-  
(Continued on page 9)



In effect, SIPC is urging this Court to adopt the requirement that a securities lender cannot be a customer under subsection VI unless that lender is already a customer under subsections I through V, in which case subsection VI adds nothing to the definition. To accept that unjustified requirement, this Court would have to presume that Congress has twice adopted subsection VI (in 1938 and again in 1970) as mere surplusage.

The SIPC/Trustee brief openly admits the above in its discussion of SIPC's unsuccessful attempt to have Congress repeal subsection VI through SIPC's proposed Securities Investor Protection Act Amendments of 1975:

The amendment would not have affected the rights of cash and margin customers who lend securities from their trading accounts to their broker and do not receive consideration for their loans. [SIPC/Trustee Brief at 19, note 19]

Thus, although the SIPC/Trustee brief rests largely on the argument that subsection VI applies solely to cash and margin lenders who lend from "trading accounts" (SIPC/Trustee Brief at 23-27), the above statement reveals that such lenders are already customers, with or without subsection VI.

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(Continued from page 8)

change Act of 1934, as amended (15 U.S.C. § 78h(c)), come within subsection VI of the definition. (SIPC/Trustee Brief at 22) This is a new argument, and there is no basis for it in the 1970 Act or elsewhere. In addition, it should be noted that Section 8(c) does not apply to securities loans from customers to brokers or dealers. Instead, that section prohibits brokers and dealers from lending the securities of customers to third parties without the customer's written consent. The third test is both erroneous and irrelevant.



SIPC has explained too much. Clearly, SIPC is asking this Court to do what Congress has refused to do: repeal subsection VI in order to bar the usual kind of securities lenders from customer status. If margin and cash customers who lend securities from trading accounts are already protected by subsections I through V, then who did Congress intend to protect under subsection VI if not securities lenders such as Yale?<sup>6</sup>

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<sup>6</sup> Unlike SIPC, the SEC admits that subsection VI "could be construed as providing SIPC protection to persons who lend their securities to brokers." Statement of Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission, Hearings on H.R. 8064 [Securities Investor Protection Act Amendments of 1975] Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 1st Sess. 164 (1975).

## CONCLUSION

For the foregoing reasons and for the reasons stated in the principal brief for Yale University, the judgment appealed from should be reversed and the Bankruptcy Court ordered to allow the claim of Yale as a "customer" under the 970 Act, with all of the rights and privileges of such a customer.

Respectfully submitted,

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Dated: April 21, 1977

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CERTIFICATE OF SERVICE

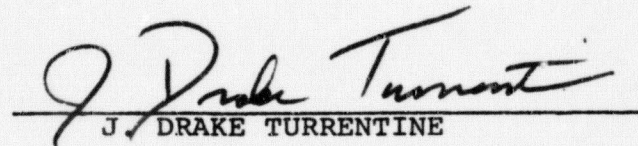
I, J. DRAKE TURRENTINE, attorney for Yale University, hereby certify that on this 21st day of April 1977, I served two copies of the Reply Brief of Claimant - Appellant Yale University upon each of the following persons by depositing a copy thereof in the United States mails, post paid, addressed to them as indicated below:

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